SOLVING THE HOUSING PROBLEM

Lessons From Poland and Hungary in Creating a New Housing Finance System

Rebecca Black
Krzysztof Jaszczolt
Michael Lee

USAID/Warsaw
Regional Urban Development Office, Central Europe

June 2000

CONTENTS

Features

Acknowledgements

This briefing describes the lessons learned by USAID from the development of housing finance systems in Poland and Hungary during the first decade of transition from centrally planned states to market democracies.

In preparing this briefing, we interviewed a number of people—especially those named in the text—who were generous with their time and opinions. We would like to thank them for this, while absolving them of any responsibility for any misinterpretations of their remarks. We should, however, like to acknowledge special debts of gratitude to Katherine Mark of the Urban Institute, Budapest, and to Sally Merrill, who led the consultant team from the Urban Institute in Poland from 1996 to 1999.

We would like to draw special attention to the particular role of three people who, for USAID's (then) Regional Housing and Urban Development Office (RHUDO) in central Europe, played a crucial role in helping shape the housing finance systems in Poland and Hungary by directing USAID's assistance programs in the field. They are Sonia Hammam, RHUDO Director from 1991 to 1994; Bill Frej, RHUDO Director from 1995 to 1997, and who later became USAID/Warsaw Mission Director; and Larry Birch, Program Manager for USAID in Hungary from 1995 to 1998.

We, the authors of this briefing, have drawn on our own experience as managers of housing finance programs for USAID in Poland and Hungary. We must express the usual caveat: that the conclusions in the following pages represent our own personal views. We alone are responsible for any mistakes, or errors of judgment.

Finally, we should like to express our very considerable pleasure at having had the opportunity of participating—even if in a small way—in the development of the housing finance systems in Poland and Hungary.

Acronyms and Abbreviations

DIM	Dual Indexed Mortgage
DPM	Deferred Payment Mortgage
EBRD	European Bank for Reconstruction and Development
HG	Housing Guaranty (loan)
NGO	Non-Governmental Organization
OTP	(Hungary's state-owned savings bank)
PLN	(new) Polish zloties
PKO BP	(Poland's state-owned savings bank)
RHUDO	Regional Housing and Urban Development Office of USAID
USAID	United States Agency for International Development

SOLVING THE HOUSING PROBLEM
Lessons from Poland and Hungary
in Creating a New Housing Finance System

1. INTRODUCTION

The Purpose of this Briefing In 1990, Poland and Hungary chose—like most countries in the developed world—to move to a system of financing housing largely from private capital. This entailed the creation of a system with individual mortgages for household purchase, construction loans for builders, and entering into partnership with commercial capital markets for developing social housing for poorer households.

By the year 2000, Poland had developed an effective mortgage system: competitive, relatively efficient, accessible to a large part of the population, and reasonably robust. Hungary's system had developed along somewhat different lines, and under different circumstances. Currently less active a market than Poland's, it promises to become a model of its kind. Although mistakes have been made, this is a story of success.

This briefing manual, then, draws out the lessons learned from the experiences of Poland and Hungary in the development of a market-based housing finance system*. It is primarily intended to be of value to professionals in those countries struggling with the early stages of reform of their housing finance systems. It is intended to be read by bankers and government officials, real estate professionals, NGOs and consultants, as well as by program managers from USAID and other donor organizations.

---

* Although we understand the importance of a *public* housing finance system—e.g. the use of public funds for the support of disadvantaged households—and its interrelationship with a market-based housing finance system, the latter is the main focus of this briefing.

It may also be of interest to those professionals in Poland and Hungary who are working to further strengthen their own housing finance systems. It may help them to step back from their everyday lives and see how others view their efforts, as well as to understand the consequence of different choices in a neighboring country.

Since USAID has been engaged in supporting the development of these two systems between 1991 and 1999, the following pages are necessarily colored by our perspective. We have, however, attempted to provide as objective a view point as possible. We have also tried to keep this briefing to a readable length: in the interests of brevity, we have necessarily simplified the presentation and have omitted findings we consider to be of lesser significance.

The lessons of development are often not absolute. In some cases, we have been able to say with some certainty that such-and-such a path *must* be followed if a sound housing finance market is to develop. In other cases, we can say no more than that a particular path has been followed in Poland or Hungary, and that it appeared to work (or not to work); but that we do not have enough evidence to generalize for other countries and other circumstances.

After summarizing the history of development of the sector in the two countries, this briefing defines some of the preconditions necessary for starting a housing finance system. It then discusses ways in which a housing finance system might be structured, and how the institutional capacity may be fostered and strengthened. Finally, some conclusions are drawn about the ways in which program managers in foreign donor agencies and national governments might most effectively accelerate the development process.

Why Does Housing Finance Matter?[1] *Housing* matters as a major quality of life issue. Choice in housing is a key component of any democratic society. The way that housing is *financed* can have a major, positive, impact on the national economy, financial markets and the quality of life.

<u>Impact on the economy</u>

- A soundly financed housing sector can play a major role in economic growth and economic stabilization, through the creation of jobs in construction and materials, demand for new enterprises, the financial sector, and indirect impacts through subsidiary activities, including infrastructure, materials, furnishings and services.
  Housing costs, including housing related services, borne by Polish households accounted for 19% of consumption expenditure of the household sector in 1998, and represented 13.6% of GDP.[1]

- A well developed housing sector can significantly mitigate unemployment, since housing shortages can severely restrict labor mobility.
  A 1993 study found that housing shortages reduced employment in Poland by up to 16%.[2]

- In former centrally-controlled economies, such as Poland and Hungary, housing was a major drain on public finances. In contrast, a market-based housing finance system employs—and is able to attract—private sector resources to provide housing for the greater part of society.
  In the 1980s, at least 10% of the national budget was spent on housing. Restructuring of the housing sector enables resources to be plowed into more productive uses.[3]

Impact on the Financial Sector

- A developed housing finance system allows capitalization of surplus resources in long term real estate investments, which are relatively safe, inflation proofed and generate a stable flow of revenues. The need for such long-term investment opportunities arises in connection with reform of the social security system and the appearance of pension funds.
  In the 1980s, real estate assets were estimated to constitute about 57% of capital accumulated in the world economy as a whole (residential housing accounts for about 41%). It was almost twice as much as the value of corporate shares and bonds combined.[4]

- Long term mortgage loans can be used by banks to improve the term match of assets and liabilities, allowing for effective management of interest rate risk. A well regulated mortgage lending sector increases the stability of the banking system.
  The value of the consumer mortgage portfolio held by banks grew from as little as 0.3% in 1996 to 1.1% of the total of bank assets in Poland in 1999.[5] *In developed economies, this ratio is much higher (44% in the U.S.; 37% in Great Britain*[6]*). Experts predict that, assuming continuing stability and favorable macroeconomic conditions, this percentage is likely to increase fairly rapidly in Poland, reaching 10% of the total assets in the next few years.*[7]

- In order to purchase new houses, households must accumulate capital for downpayment. Many researchers have found that the housing sector is responsible for generating a significant portion of household saving. Savings translates into more capital available for investment by the commercial and industrial sectors.

Impact on the Quality of Life

- Housing matters as a major quality of life issue, particularly in countries where individual control through ownership was previously denied, by law, through limiting options, or by making it unaffordable. While choice in housing is a key component of any democratic society, it can be achieved only on the basis of a sound, market-based, housing finance system.

- Real estate represents a major capital resource for many individual households. It constitutes an important form of personal wealth, conditioning popular attitudes towards the state and the economy. Sound housing finance and real estate sectors allow citizens to benefit from this capital, and thus provide the basis for further development of democracy and the free market economy.

2. THE GROWTH OF HOUSING FINANCE IN CENTRAL EUROPE

At the start of the 1990s, the housing situation in Poland and Hungary was characterized by deteriorating upkeep, declining supply and lack of choice. The following sections describe how, with USAID help, the housing finance sectors evolved in these two countries.

Similarities and Contrasts in Poland and Hungary

- Both countries chose to support unsubsidized mortgage systems; although Hungary has continued with mortgage subsidies. Both have dramatically decreased direct subsidies.
- Poland used an apex lender to promote competition; Hungary did not.
- OTP has continued to dominate the Hungarian housing finance market, responsible for 90% of loans made. In Poland, while PKO BP still represents around 60% of the value of all loans made, some ten other banks have aggressively pursued the market and are increasing their share as time moves on.
- Banks in both countries are still reliant on domestic capital from deposits. Secondary sources—mortgage bonds, issued by specialized mortgage banks, in Poland and Hungary—may in the longer term become important to the primary market. Hungary has encouraged the growth of (subsidized) Building Societies; Poland has not.
- Special mortgage instruments to mitigate inflation were used in both countries; Poland relies on the Dual Indexed Mortgage more than any other country in the world.
- Neither country has a supervisory system specific to mortgage lending. Hungary focused heavily on addressing risk issues through banking techniques.

Poland[8]

The Inheritance At the beginning of the 1990s, Poland inherited a centrally planned housing finance and delivery system: heavily subsidized, inefficient and unresponsive to people's needs. The standard of housing was well below the European standards to which the country aspired, although it was in fact no worse than for most other countries at a similar stage of economic development.[9] By 1990, housing production was already in decline; this would continue for several more years before a modest upturn was seen.[10] According to Irena Herbst, a leader of Polish housing finance in the 1990s, housing was then "treated as a kind of equipment indispensable for initiating the economic process. It was not a facility for its future user."[11] For the user, however, housing was cheap, and was seen as something close to a social right.

Although people in the rural areas were somehow building their own housing, the new Poland inherited no institutional infrastructure for urban housing delivery. There was no profession of developer, no real estate broker; mortgage collateral was not enforceable. Local governments—which were established only in 1991—had no experience with managing the communal housing stock they had inherited from central government, and little ability to facilitate any form of private housing construction.

The only available form of formal home financing in the 1980s was subsidized but severely restricted credit from the State Savings Bank, PKO BP, mainly for members of cooperatives. This was supplemented—in rural areas—by informal financing for private housing construction.

New Beginnings (1990-95) With housing subsidies in the 1980s having accounted for 2 to 3% of GDP, and 8 to 13% of total budget expenditures, it was no wonder that the government took it as a priority to reduce public expenditures on housing.[12] At the same time, housing was still seen by political economists as an engine of economic growth; there was "therefore" seen to be justification to bolster housing production by whatever nonbudgetary means were appropriate.[13] Several government initiatives therefore ran in parallel to encourage private financing of housing and to reduce the government deficit, which were later to achieve a sectoral transformation. (Annex A summarizes and illustrates the main stages in the development of the sector.)

Among the more significant of the early developments was that PKO BP announced the cessation of its subsidized housing loans which, because unsustainable and inconsistent with a market economy, both created an uncompetitive environment for private lenders and led to unrealistic public expectations of low interest rates. However, because of a considerable overhang of commitments by PKO BP, it was not until 1996 that the last subsidized loan was actually disbursed.

Simultaneously, the Polish Government turned for help to USAID and other donors in establishing the foundations for a market-based mortgage delivery system. A Mortgage Fund was capitalized with funds from the World Bank, as well as from USAID, the EBRD and the Government of Poland, in order to on-lend long-term capital, at market rates, to commercial banks for mortgage loans and construction finance. Because Poland was faced with continuing high and unpredictable interest rates, the basic instrument employed was the Dual Indexed Mortgage (DIM), indexed to changes in earnings and interest rates. (DIMs are discussed in more depth on pages 33-35; USAID's Housing Guaranty loan, on page 57.)

Other than the few banks that chose to participate in the Mortgage Fund, only two other banks at that time opted to offer mortgage loans and construction finance to their customers. One was the still-subsidized PKO BP; the other was the Polish American Mortgage Bank (PAMBank), financed in part by the Polish American Enterprise Fund, itself supported by USAID (see page 40).

The first five years of the decade did not see a great public appetite for mortgage loans. There were many reasons for this, including the following:

- uncertainty by the banking industry about the future of mortgage banking and, therefore, little active marketing of mortgages;
- the complexity of the DIM, and the administrative arrangements associated with use of the Mortgage Fund, therefore a slow take-up by the banks;
- a low public appetite for long-term, market-priced, loans in conditions of economic uncertainty, combined with residual competition from PKO BP's subsidized loans, and with high demand for newly-available consumer durables and foreign travel;
- unreliable real estate institutions, including developers and real estate brokers, and property registers;
- a widespread public expectation—derived from heavily subsidized rents for public housing—that a "normal" level of expenditure on housing is low; and
- initial inertia in changing the public finance system from one intended to directly boost construction, to one designed to stimulate private sector capital finance.

The latter part of the period saw moves by the main actors—central government, the bankers, the real estate industry—all assisted in one way or another by USAID, to change all of these systems and attitudes.

The Take-Off Phase (1996-1999) Many initiatives ran in parallel to complete the first phase transformation: essentially, a turn-around in all of the areas noted above. This was achieved, in part by an increasing, although unstated, consensus on the part of the main players on the optimum nature of a mature housing finance sector (see Chapter 4). The take-off of mortgage lending was, of course, greatly assisted by improving macro-economic conditions: falling inflation, growing expectations of stable economic growth; and political stability, regardless of government composition. It was also assisted by the high level of liquidity of the banks, especially during the early part of this period; and their perceived need to attract customers by providing an increasingly wide range of services.

At about the same time that USAID held the first national conference on market-based housing finance, (the "Building on Progress" conference), many of the important national print media and radio stations introduced supplements and programs dedicated to housing, and usually including serious discussions on housing finance issues.[14]

Assisted in large part by USAID advisors, the Mortgage Fund succeeded in spearheading a remarkable transformation in the banking industry. It demonstrated to commercial banks that mortgage and construction lending is profitable. It established industry standards for loan origination and underwriting. It created a focal point for policy discussions on the sector. Although the Mortgage Fund's DIMs were never to prove popular, the mechanism itself, together with PAMBank, developed the initial public demand for unsubsidized mortgages.

PKO BP disbursed the last of its subsidized loans in 1996. This bank was to become one of Poland's innovators. Jacek Laszek, himself one of the pioneers of the industry through the 1990s, says of PKO BP that "due to its size, marketing capacity and open attitude towards innovations, it managed to design, introduce and popularize its own version of a dual rate mortgage".

These initiatives, together with growing confidence by individuals in Poland's economic stability and therefore in their own longer term prosperity, and with added incentives given by real increases in the monthly costs of public rentals, served to raise popular demand for long-term housing finance.

The sector grew in size and robustness. Every few weeks saw a new bank announcing its intention (and, by implication, ability) to start mortgage and construction lending; the variety of loan instruments increased, as did the ability of the population to reach a bank giving home loans. With increasing competition, spreads started, hesitantly, to fall, and the quality of service to increase.

In the initial years—indeed, until the present—commercial banks financed their long-term lending for housing either from the Mortgage Fund or, more often, from their own short- and medium-term resources. In order to reduce the transformation risk and, potentially, to lower lending costs, the Government passed a law in 1997 which permits the creation of specialized mortgage banks, a form of bank which was active in Poland before the war. Raising capital through the issue of mortgage bonds, mortgage banks will be able to access capital markets directly. Sale of the bonds will depend on stable, lower interest rates. With inflation now under control and at the single digit level, the first licenses for mortgage banks have recently been issued, with several other banks having expressed a firm intention to enter the market.

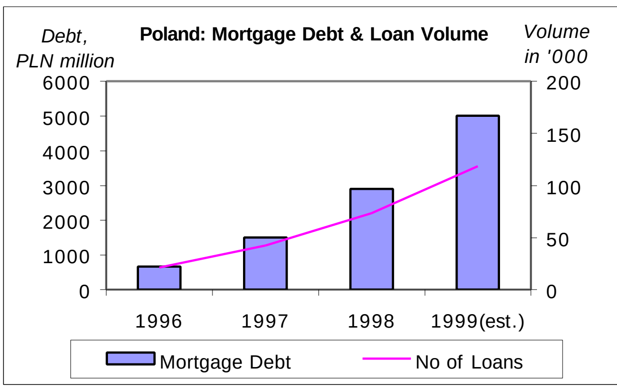
Other components of a market-driven housing delivery system were simultaneously put in place, in most cases with direct USAID help in developing the capacity of the then-immature Polish organizations. A Polish Association of Home Builders has become a self-sufficient organization representing small and medium-sized builders and developers. The professions of appraiser, real estate broker and property manager have become established and recognized in law, with their own professional associations. (See *The Real Estate Professions*, page 45.) Bank training schools have started to offer a variety of training courses in housing finance subjects. The Polish Bank Association has set up a permanent Housing Finance Committee, with a salaried secretariat. Banks are cooperating with real estate brokers and developers in loan origination.

There were advances, too, in the development of social support schemes for housing for economically weaker households. A government scheme targeted towards middle income households is the non-profit housing association (TBS), primarily for the construction of rental housing, in receipt of substantial subsidized loans from the National Housing Fund and grants-in-kind from local authorities. Rents of local authority apartments are in the process of being de-controlled, with a safety cushion provided by housing allowances for poorer households.

At the same time, there has been a change in public attitude, that housing finance is an integral sector of the economy—not simply part of an engine for growth.[15] There has thus been a gradual shift in public financing for housing, from simple reliance on direct subsidies to reduce prices, to indirect leverage of private capital (e.g. to finance TBS development or renovation of older apartment blocks), schemes to encourage savings for housing, and more targeted assistance for poorer households (see charts on page 36).

The Present In 1996, other than the four banks participating in the Mortgage Fund, PAMBank and PKO BP, there were only two other banks making unsubsidized mortgage loans.[16] Today, perhaps 10 banks actively compete for mortgage loans, and a further 20 offer commercial loans for housing from one or more of their branches. In the last twelve months, the value of mortgage loan assets held by these banks doubled; over 150,000 loans have been sold in the last four years. A variety of loans are being marketed, including two variants of the DIM, and conventional variable rate mortgages denominated in Polish zlotys and foreign currencies. Loans are available for the purchase of new and existing housing, for renovations and extensions, and for construction. Perhaps 20 percent of new home buyers now take out a mortgage, and the proportion is rising.[17]

With these advances, the sector has attained its first, major, stage of development: the basic policies, instruments and skills are in place to be able to boast of the existence of a market-based housing finance system for mortgages and construction loans. Nevertheless, the sector is still small and relatively fragile: it is inefficient and therefore expensive to its customers; it may be unprofitable to several participants; it is vulnerable to a variety of risks, largely unquantified and not always recognized by the participants; because barely regulated, it is open to exploitation; and, although it has the good will of the government, its growth is not yet well supported by legislation. Much remains to be accomplished before the transformation of the sector is complete.



Hungary[18]

Hungary did not share the scale of Poland's tragic destruction during the Second World War: more of its housing stock and urban infrastructure was left intact. Today's declining population, and aged but available stock provides Hungarians with relatively abundant and good housing. The politics of housing however, have remained important, prompting continued government involvement in the sector.

Hungary was among the first of the Central European countries to embrace private market principles. While other Eastern bloc countries were turning to cooperatives and rental housing, Hungary began its shift to private ownership of housing in the 1970's. By 1990, over 70% of the housing stock was already in private hands, the multi-family building units having been converted to condominiums. OTP, the large state owned savings bank, supported the early move towards private ownership by issuing mortgages, albeit heavily subsidized, and a continuing heavy burden on the state budget.[19]

The Government continues to provide direct and indirect subsidies, including two generous new ones in the recent past. The supporting institutions—development capacity, real estate professions, access to land, etc—remain immature. There are positive signs, however, that more active and competitive private lending market is emerging. Several banks have recently entered the mortgage market, providing both their own product and that subsidized through the recently enacted mortgage bank system. New products such as condominium rehabilitation loans have been introduced. Renovation is becoming an increasing market for finance and, of course, construction work. Over the past seven years, the Government enacted laws and regulations intended to decrease credit risk and thereby to increase lenders' security. Property values have surged in the last two years, and new construction began, finally, to increase.

Hungary began the reform period with a huge housing debt, which meant that in 1989 the Government was spending some 17% of its budget on the housing sector[20]. In 1991, the World

Bank and USAID engaged with the Government of Hungary in discussions about housing sector reform. The Bank and Hungary did not reach agreement on a path of reform: USAID became the primary donor supporting Hungary's housing sector reform.

The focal point became a proposed $60 million USAID Housing Guaranty (HG) loan to the Hungarian Government, to be used to capitalize a number of mortgage lenders. The loan was never borrowed, but the policy changes required to meet the loan conditions were all made. According to Cseh Pal of the Ministry of Finance, "the HG program focused restructuring of the housing finance sector. It helped us to overcome our lack of consensus…and restructured our thinking about Government and housing". To meet the conditions of the loan, the government formed a Housing Policy Committee which issued a policy concept statement rationalizing and targeting subsidies.

In order to help make mortgages affordable with the elimination of the old interest subsidy, the government encouraged OTP (and other lenders, but only one other indicated interest) to use the USAID-designed Deferred Payment Mortgage (DPM), an instrument comparable with Poland's DIM. The DPM enabled households to initiate a loan with relatively low payments set through a fixed, low, interest rate, with the difference between market and set rates being "deferred" until later during the loan repayment period.

USAID provided considerable training, especially training of trainers, in the introduction of the DPM—training which was to prove valuable in the introduction of marketing of all mortgage products. The average size of DPM loans was double that of the standard variable mortgage, reflecting one of the key objectives of the DPM, to enable Hungarians to afford larger sized loans. The instrument continues to be offered by OTP as one of its products. By 1998, 7,000 DPMs had been issued, representing 30% of the total volume of lending. The fact remains, though, that housing loans have been underutilized, with little more than 10% of new housing being financed by a mortgage loan.[21]

Hungary stands out for its efforts in reducing credit risk and in making many of the legal changes needed. This is perhaps a reaction to a history of defaults on old loans with, therefore, a more acute awareness than in Poland of the real potential for default. With recommendations coming from the credit risk committee, the government passed a series of progressive laws, including:

- a law no longer requiring landlords to provide alternative housing to evicted tenants (1993);
- amendments to the civil code which allow banks to bypass the requirement for judicial process for foreclosure and eviction for mortgage default if they adopt (an expensive) notarized loan contract;
- a law on Mortgage Banks and Mortgage Bonds that changed the priority for payment to a mortgage lender from the proceeds of a foreclosure sale from last place to fourth, ahead of taxes, social security, and other public debt (1997).

Banking behavior has, however, not yet changed, highlighting the difference between legal and cultural change. Foreclosures have been undertaken, but to date there have been no evictions.[22] Banks remain extremely hesitant to move to foreclosure.

In 1997, the same year as Poland, Hungary passed a mortgage banking law, an act primarily driven by the need to finance agricultural land. The Land and Mortgage Bank is also entering the housing market. Hungary has also embraced Housing Savings Banks, modeled on the German/Austrian Bausparkassen.

The percentage of the government's budget devoted to direct housing subsidies has decreased to 3%. USAID played a role in helping the subsidy systems become more transparent, efficient and, slowly, more targeted. More emphasis has been placed on up-front grants (for new house purchase, grants to match savings in contract savings schemes, and rental housing grants to local governments). And the way that subsidies are determined is more effective, insofar as people now realize that housing—and housing subsidy—is not a right, but that they need to qualify.

According to the Housing Director in the Ministry of Finance, the subsidies are needed as long as interest rates stay high. He, like several of the bankers, believes that the sector is on the verge of a major increase—in lending, in construction, in use of the various housing schemes to increase housing purchase. Interest in the Land and Mortgage Bank has increased with new contracts under negotiations, real estate prices have recently increased, and as incomes are growing and rates decreasing (with a new government subsidy), the conditions appear prime for a resurgence of mortgage lending.

In 2000, it is not clear that the Hungarian housing sector has yet completed the shift to market orientation. The mortgage lending volume is only just beginning to increase after a decline that began in 1993, coinciding both with a decrease in interest rate subsidies and a general economic recession. OTP continues to hold a very dominant role, with about 85% of mortgages issued. The lack of competition is said to be one of the most critical problems in the sector.

3. WHAT ARE THE PRECONDITIONS FOR THE START-UP OF A MODERN HOUSING FINANCE SYSTEM?

Policy makers will want to aim at the ultimate development of a housing finance system with a number of characteristics. It should be efficient (e.g. with a spread between cost of funds and loan price of no more than—say—2%); affordable (e.g. to at least 60% of the population, without subsidies); providing a choice of mortgage instruments; well regulated; and robust (recognizing and pricing unavoidable risks). However, for the purposes of this briefing, we have chosen to adopt a looser—and unquantified—definition of a "modern housing finance system", as one in which mortgages of ten years or more are readily available, are affordable to a substantial part of the population, and are provided by several banks in competition with each other.

When the governments of Poland and Hungary chose to create market-oriented housing finance systems, assumptions were made about what conditions had to exist—in the legal framework, the macro-economic situation, the financial markets, the construction sector—in order for such systems to function. Some of these assumptions proved true, some are less axiomatic.

Catalysts in Jump-Starting a New System[23]

In Poland, the ending of subsidized lending, provision of support to a liquidity facility, and introduction of an affordable mortgage product were all important catalysts in taking the first steps in establishing a housing finance system. An environment of falling real interest rates also enhanced the attractiveness of mortgage loans. Each country will need to identify its own "market-breakers"—barriers which would prevent the development of market-based finance—and "market catalysts" (which may be an institution, a pilot product, a demonstration of affordability, etc).

We look below at selected environments which are normally assumed to contain critical elements for the start-up of a modern housing finance system:

the legal framework
the banking structure
the housing delivery system
government policy, and
the political and economic context.

Legal Framework

The following elements of a legal framework are clearly essential[24]:

- A mortgage law of some form, making real estate a source of collateral for loans.
- A basic registration system, enforcing ownership rights, and recording ownership and liens on property.
- An enforcement law: some provision for the lender to enforce rights in case of default.
- A basic contract law, establishing legal requirements to fulfill the terms of an agreement.

Experience from Poland and Hungary suggests—contrary to perceived wisdom—that the following, although desirable in the long term, are *not* essential in the short term:

∇ An *efficient* registration system. The system in Poland is very inefficient and sometimes requires numerous months for new title and mortgage liens to be recorded. While this creates inefficiencies in the system, it has not inhibited mortgage lending from reaching over 100,000 loans.[25] In Hungary, the system was very efficient before mass privatization extended registration time in the cities from as little as eight days, to several months or even years. So far, there has been little obvious impact on lending.

∇ A foreclosure law, permitting a lender to take possession, or proceed to a forced sale, of a mortgaged property without providing alternative housing for the former residents. There is some evidence that passage—and use—of this law is necessary to achieve high volume and speed in mortgage lending, but in both Poland and Hungary actual foreclosure leading to eviction has been little used. This has not seemed to limit the volume of mortgage lending to any significant degree in Poland. Hungary, unlike Poland, has had a recent history of high default rates, mostly attributable to changes in formerly subsidized loans. The reality of bad loans in Hungary is believed to play a role in higher interest rates, lower loan-to-value ratios and, above all, more careful (and thus lower volume) lending.

Default Risk in Hungary and Poland

K&H Bank (Hungary)
According to Balazs Horvath, the Bank has not yet had borrowers in default. They assume, however, that the foreclosure process would be lengthy and difficult, and it would therefore be unlikely that the Bank would risk the bad publicity of a full eviction. Instead, they carefully screen applicants, loan at low loan-to-value ratios (40%-50%), and compensate for any losses through higher interest rates.

GBG Bank (Poland)
Q: Poland changed its law so that banks can foreclose on property in the case of default without going through a judicial process , evict, and resell the property. Has GBG used this provision?
Ms. Stefania Czuba: The process of foreclosure would take 4-5 years in the courts. We could never evict someone from a property.
Q: Does this deter the bank from mortgage lending?
Ms. Czuba: If we want to make a profit, we have to lend!

∇ High priority for mortgage lenders. While perhaps important to achieve high volume, Polish law gives banks fifth priority in the case of default—and yet it has the highest mortgage loan lending rate of all the countries in central Europe.

Structure of the Banking System

The following elements are needed in the banking system to support development of a modern housing finance system:

- ♦ A liberalized banking sector with (some) competition and a basic regulatory system.
- ♦ A network of bank branches, which provide banking services to households in most of the large and medium sized towns.
- ♦ A broadly competitive banking system. OTP remains dominant in Hungary. However, if monopoly enables rates to stay high and therefore discourages demand, competition becomes increasingly important. Poland's system is very competitive, and it seems reasonable to conjecture that the existence of competition has improved intermediation efficiency, increased consumer choice and improved service standards.

The following condition is not so critical in the near term:

- ∇ Match of long term capital assets to long term loans. Both Hungarian and Polish banks have successfully used short term assets to provide longer term loans. This was less of an issue in Hungary, since the main lending banks have also been deposit-taking institutions (OTP and the Housing Savings Banks). However, as mortgages begin to form an increasingly large proportion of a bank's portfolio, so it will become increasingly important to reduce the interest rate risk by financing long term loans from long term assets.

- ∇ A regulated mortgage lending market. The commercial banking system is well regulated by the central banks of both countries; but neither has a system of regulation specific to housing finance.

The Housing Delivery System

There are a few basic preconditions for the development of a housing industry, hence of a housing finance system:

- ♦ Some building capacity, with a reasonable record of reliability and honesty.

- ♦ Land availability: land serviced with infrastructure, with title, in locations in demand by prospective buyers.
- ♦ A system of sales and valuation.

GEO, Krakow

Adam Zaremba-Smietanski founded GEO in Krakow, Poland, as a residential building company in 1993 as a company with three employees, including himself. Today, it is the largest residential development company in the city, has built 1,100 housing units in 14 different projects, and has site control over 20 hectares of building land in Krakow and Wroclaw. The company does its own marketing but contracts out for construction.

Mr. Smietanski credits the Mortgage Fund with his ability to become Krakow's largest builder and soon, he hopes, the largest in Poland. In 1993, he approached several banks for construction loans but was turned down as too high a risk—as were most such applications at that time. PBG, a bank participating in the Mortgage Fund, brought GEO's application for a 176 unit project to the Fund and, out of 60 other applications, became the first to get approval. Subsequent mortgage loans to his buyers paid off the GEO loan. By his own admission, Mr. Smietanski has learned a lot about the building business, and in combination with higher quality construction workers, has improved the quality of his projects since those early days. And competition helps: GEO had 4-5 competitors three years ago, 10 two years ago, but 40 this year. The market is beginning to boom.

What is not needed in the start-up period? The following elements were not present during the start-up periods on Poland and Hungary:

- ∇ Fully experienced developers and homebuilders, special materials, new construction techniques.
- ∇ Foreign investors in real estate, with a strong financial background.
- ∇ Efficient permitting, efficient public land auctions.

∇ Fully matured brokerage, valuation, and property management capacity.

Government Policy

The following element is essential:

♦ Political commitment to a market-oriented economy and to a market-based housing finance system. Although governments may change, and policies with them, it is essential to have continuity in commitment to reform. Poland's experience of annual threats—never yet implemented—to withdraw tax concessions for new construction is clearly disruptive to the development industry. It appears, however, to have had the effect of providing an annual, incremental, boost to construction, as builders maximize their tax breaks in the belief that the concessions may be withdrawn the following year.

What is not so clearly needed?

∇ Consistent leadership within the government itself. Willingness to respond to pressure from housing advocates outside government can be sufficient for some period of time. Although government action is needed to establish some of the preconditions listed above, much of the initiative for development of a housing finance system can be taken outside of government—e.g. in the banking sector, by real estate lobbyists, academics, developers or consultants.

The Political and Economic Context

What is needed in the macro context?

♦ A widespread expectation of stability or decline in inflation rates, and of stability or increase in personal incomes. There are two tools for use in unstable economic environments—indexed mortgages, and loans in foreign currencies. However, these tools are not particularly user-friendly, and experience shows that a population not accustomed to long term loans is unwilling to take on long-term financial commitments in an uncertain economic environment, or under conditions of personal uncertainty.

♦ Limited access to subsidies. Hardcore subsidies can both depress demand for mortgages (e.g. subsidies for public rental housing), and can severely distort demand (e.g. by increasing demand for mortgages linked to one bank or type of banks, thus reducing the potential for competition, with its longer term benefits.) However, both Poland and Hungary have experience of a variety of subsidies—see pages 36 to 38—and, to different degrees, have succeeded in developing market-driven housing finance systems.

♦ Willingness to pay market rates for housing. Poland and Hungary—like most other transition countries—have a history of housing being perceived as a social right: traditionally, only small payments are required of tenants of public housing. If, then, housing payments have averaged—say—5% of household income, there needs to be a considerable shift in willingness to pay in order for households to move to pay, say, 25-30% of income for a mortgage. This has probably proved to be the greatest barrier to popular acceptance of mortgages as an affordable way to own a home in Poland. It can be overcome in the longer run by reducing rent controls, perhaps accompanied by subsidies targeted to needy households.

♦ Leadership. It is a truism that a champion is needed for development of a housing finance system. This may be an institution, or an individual. The champion does not need to be in government. The leadership will emerge on an ongoing, though not necessarily constant, basis.

Two further conditions, although desirable, are not essential for the development of a modern housing finance system:

∇ Absence of subsidies for middle income housing. Both Poland and Hungary have continued to have substantial subsidization in the housing sectors, through the tax system as well as direct public expenditures.

∇ A change in culture. Observers have claimed that Central Europeans are unwilling to borrow long term for housing, not least as a partial explanation for the low rate of borrowing in Hungary.[26] As 20% of new housing in Poland is now bought with mortgage finance, this claim is palpably untrue as a generalization. The growth in demand in Poland—unlike Hungary— has been accompanied by widespread advertising of the availability of mortgage loans, which doubtless played some part in creating the appropriate climate for change.[27]

In summary:

- The national context does not have to be perfect, but some basics are required. A system can still have subsidies to middle income households and non-market rents; inefficient regulations; state-owned banks—all of which are evident in Poland and Hungary.

- Creating a housing finance system is a process, intertwined with maturation of the financial sector and the overall economy. The lesson is very clear that reform of the housing and mortgage sector can indeed be done through phases and over time, as economic, administrative, and political realities enable change, and as the overall financial sector and economy mature.

- Articulate local leadership is required, which comes forward sufficiently often to keep progress moving.

- Finance is only part of the housing picture—developers/builders, real estate markets, local government procedures and processes should all be emerging along with the finance sector.

---

4. HOW SHOULD A HOUSING FINANCE SYSTEM BE STRUCTURED?

Like most countries in Central and Eastern Europe in the early 1990s, the new Polish and Hungarian governments inherited banking systems with a single dominant player in the housing sector. Their subsequent paths of development, moving to systems with a complex interaction of private and public sector actors, show more similarities than contrasts.

Although there is no such thing as a single, ideal, structure of a housing finance system—there being a multitude of workable alternatives—some lessons can be drawn about certain necessary elements of any system, as follows:

- Sources of capital
  - Short-term assets
  - Apex lender
  - Building societies
  - Secondary market
- Affordability and choice
  - Competition
  - Affordable mortgage instruments
  - Subsidies

Sources of Capital

Considerable concern was initially paid in Poland and Hungary to the question of the sources of capital for mortgage lending. A number of solutions have been proposed in both countries to the perceived need for long-term funding, including the establishment of apex funds, the creation of "building societies" to encourage savings for housing, and the creation of mortgage banks to access capital markets directly. The principal solution was to use the banks' own short-term assets.

Short-Term Assets The *promise* of capital funds in Hungary and Poland played a significant role in getting both housing systems moving, with the Mortgage Fund in Poland being particularly important in enabling new, smaller banks to enter the

GBG Bank, Poland

GBG is one of the many new banks founded in the early 1990s. It is a provincial bank with 11 branches, most active in Silesia. In 1994 its chairman saw market potential in housing and began negotiations with the Mortgage Fund. It signed an agreement with the Fund in 1995, and made its first loans in 1996.

GBG participated actively in Mortgage Fund training. It found the lending guides invaluable, and still uses versions of them as its procedural documents. A small bank, it also saw the availability of longer term capital as a major inducement into the market. While it continued to participate in the Mortgage Fund for several years, GBG headquarters identified alternative capital sources and went out on its own. A major incentive was freedom from some of the Fund's cumbersome procedures, and an interest in marketing its own product.

According the Krakow credit officer, profit drove the Bank's interest in housing. GBG works closely with its mortgage clients, undertaking thorough credit reviews as an alternative to reliance on standard default procedures. Perhaps competitive on price, it feels a major strength is service—they claim to process applications within 1-2 weeks in many cases, and to provide a "customer oriented" service attitude. The average client works in a large company, is married and is buying a new single family home. GBG's portfolio reveals, however, that loans have been made to single individuals, with monthly incomes as low as PLN 1,400 (currently about $310) for purchase of existing apartments in multi-family buildings.

The average loan-to-value ratio has increased significantly from four years ago; the term has also increased, to a current average of about 15 years.

In 1994, the major obstacle to lending was the lack of longer term capital. Today, loan officers see the slow and cumbersome registration system as a major problem. The bank is a member of the Polish Bank Association, and turns to the Association to lobby on its behalf on such issues.

market and compete with the large state-owned banks. What is also evident, however, is that there was, and is, sufficient capital within both countries to make significant headway in establishing a mortgage credit system, without requiring specialized housing funds.

Virtually all of the lending banks relied largely on short term assets to fund long term loans. Given high levels of liquidity, this has yet to create a problem. Indeed, excess liquidity probably permitted some banks to experiment, while encouraging them to underestimate some risks of lending. In the longer run, however, and as demand for funds increases and loan terms lengthen, it will become necessary for the banking system to access long term funds (e.g. from investors in pensions or other insurance).

- The first place to look for lending capital is the banking sector itself. Short term assets can provide a sufficient lending base, at least for the initial start-up of a mortgage system.
- Alternative sources of capital may be important to foment competition from recently-created banks, short on assets.

Apex Lender An apex lender serves to provide both *capital* and *process* to a lending system. Poland chose to establish its

GBG Bank and the Mortgage Fund

"In 1993, the bank did not have a product for lending longer than 2-3 years; anyway, no-one could afford the rates and terms of such a product. Nor did the bank have the capital base. The Mortgage Fund provided capital at rates and terms (via the Dual Indexed Mortgage) that made loans affordable. The training was incredibly valuable, and so were the lending guides. The bank has adapted the guides and is still using them as the core of their operating procedures. GBG left the Mortgage Fund but we are very grateful, especially for the training." (Mrs. Stefania Czuba, GBG) system through an entity called the BudBank, which on-lent funds to participating commercial banks through the Mortgage Fund. According to the participating banks, the Mortgage Fund was instrumental in providing the technical resources needed to encourage and enable other banks to engage in the sector. (See also the discussion on the Mortgage Fund, pages 56 to 58.)

Hungary did not create an equivalent apex lender.

The major difference today between the two mortgage lending sectors is the much greater competition in Poland—see below. It is improbable that the Mortgage Fund structure was solely responsible for the much more competitive banking system in Poland, but it certainly did support the engagement of other banks in the sector. In discussions of what might have been different had Hungary actually borrowed its USAID loan, most think it would have helped more banks enter the field—although the macro-economic situation would probably anyway have precluded major lending volumes. It is also interesting to note that the new mortgage bank in Hungary believes that a number of banks have signed participatory contracts with it merely to get access to training, (a function played in Poland by the Mortgage Fund as apex lender).

Building Societies Hungary and Poland have established somewhat different forms of systems of contract savings for housing (locally known as Building or Housing Societies).

The Hungarian system is closely modeled on the Bausparkassen system in Germany. In this system, specialized financial institutions offer households fixed below-market rate savings contracts that, once completed, entitle the saver to fixed below-market rate loans to be used for housing purposes. The government subsidizes the savings through a lump sum grant payable upon completion of the contract.[28] Advisors to USAID have concluded that the systems—similar systems are also in use in the Czech Republic and Slovakia—have failed to produce benefits commensurate with their costs to the state budget. Among other things, they find that these building societies will have little impact on home ownership, will generate little additional savings overall, and are a significant (and unconstrained) burden on the government budget.[29]

The Polish building society system, in contrast, is operated by existing financial institutions. Individuals must open a contract to save for—normally—at least three years. Savings rates and the eventual lending rates are both below-market. Although not supported by cash subsidies, the scheme provides tax relief on savings, which was expected to act as a strong incentive for higher income households to participate in the scheme. In the event, it has not proved particularly popular. (A system similar to the Hungarian system was proposed by Parliament, but rejected by the government.)

Secondary Market Both Poland and Hungary spend considerable time discussing wholesale capital access for the mortgage market, called the secondary market in the U.S. Worldwide experience says that there is no right answer, as several different models have worked well[30]. Poland and Hungary both have chosen to utilize mortgage banks (Hungary's is state-owned and state-subsidized; Poland's are private and unsubsidized). As the primary market is not large in either country, additional capital is not the problem of the day, or perhaps even of the next five years.

Both Hungary and Poland have passed legislation that has allowed the creation of specialized mortgage banks. The first of these banks have recently been licensed and have started operations. One of USAID's consultants comments, however, that "the usefulness of specialized mortgage banks and secondary market mechanisms in [central Europe] is an unresolved question. Experience so far supports the view that neither offers advantages over deposit-based funding through commercial banks, at least when lending volumes are relatively small."[31]

- ♦ A secondary capital system is not needed until a number of years after maturation of the primary market.

Affordability and Choice

Competition among Mortgage Lenders As previously noted, Poland's PKO BP currently has almost 60% of the market; Hungary's OTP maintains a 90% monopoly.

Three differences stand out that may be at least partly the result of greater competition in Poland: variety of products and quality of loans, lower interest rates (intermediation efficiency) and, therefore, volume of loans.

The spread between the mortgage lending rate and the cost of funds is higher in Hungary. OTP's spread is 10%, Poland's may be 6% or less.[32] The spread is still substantially above European norms, and competition has not yet been as successful as assumed in reducing the cost of loans.

Secondly, competition between banks in Poland has created a wide range of products: foreign currency loans (with Euro loans currently predominating) along with local currency loans; a variety of terms (including DIMs); a widening use of insurance products in association with mortgage loans[33]; and increasingly customer-friendly service (some banks now process loans as quickly as within two days). Logic would say that the greater the variety of banks, the more competition on product.

Thirdly, Poland has now surpassed Hungary in the volume of mortgage lending. One noticeable factor is the level of marketing being done by Polish banks for their mortgage product—and the absence of equivalent marketing in Hungary. Many other factors may determine the volume of borrowing, but public awareness, created by competition and effective marketing, obviously can't hurt demand.

The presence of smaller banks in the system created some initial problems: they had little experience in lending and were very inefficient, perhaps to the point of deterring demand at the outset. (In the mid-1990s, the media carried a number of stories

Affordability

A constant refrain in Poland was that mortgage loans are "not affordable" (even though, somehow, car loans seemed to be affordable). With high nominal interest rates, and sufficient knowledge about the U.S. and Western Europe to understand that single-figure mortgage rates are now usual, it proved extremely difficult to explain that low-start mortgage instruments could make loans affordable in a high interest rate environment.

Poland's Dual Indexed Mortgages (DIMs) are discussed on pages 8 to 12. Poland never really solved the problem of how they could be explained in simple terms. Comprehensive marketing programs were never fully embraced by the Bud-Bank or by the commercial banks participating in the Mortgage Fund program. That DIMs did prove to be popular can be attributed to two factors: enthusiasm on the part of a few loan managers to promote mortgage lending, and considerable simplification by some banks of the personal implications of taking out such loans (often, we fear, to the detriment of borrowers).

But the DIM did prove to be affordable. Here are a few statistics of loans made by the Mortgage Fund[34]

- 10% of all borrowers had monthly household incomes under PLN1,500 (now $330)
- the average value of loans was about PLN 52,000 (now $11,500)
- the average size of house financed was 81m^2.

It proved equally difficult to get across an understanding that affordability (ability and willingness to pay for market-priced housing) can be improved by many means other than straight subsidy. The following methods of improving affordability were among those addressed by USAID:

- increasing the loan term or changing the loan-to-value ratio;
- increasing the efficiency of the permitting process, hence lowering the cost of construction;
- removing rent controls, thus increasing people's *willingness* to pay market rates;
- training bank staff in loan servicing, thus increasing bank efficiency and lowering spreads).

about the difficulties of even well-connected people in obtaining a mortgage.)

Affordable Mortgage Instruments In 1990, Poland's inflation was 685 percent; in Hungary, it was to remain over 20% annually until 1997. In those circumstances, few borrowers would have been able to repay a standard mortgage loan denominated in local currencies. The first unsubsidized loans in Poland were therefore made in U.S. dollars, a practice which allowed households to make relatively low and predictable repayments. However, banks would not have been wise to make substantial foreign currency loans to people with local currency incomes, since the risk of devaluation (whether sudden or gradual) could reduce the foreign equivalent of their incomes to a level where they could not keep up their loan repayments.

Hungary and Poland tackled this problem by using different types of mortgage instrument, both of which allowed borrowers to start with relatively low monthly payments, but which increased over time as their incomes rose. These mortgages imitate a situation with much lower inflation, and thus make mortgages affordable to middle income borrowers. They thus also encourage banks to get into the business of mortgage lending.[35]

Hungary introduced its Deferred Payment Mortgage (DPM) in 1994. This is "a standard fully amortizing mortgage, with either a variable rate of interest, for which a portion of the monthly payment is deferred, i.e. added to the outstanding principal and amortized over the remaining life of the loan. The payment amount is periodically reset to amortize the outstanding principal and deferrals over the remaining period It is in concept and in practice similar to lending the borrower a portion of the monthly payment"[36].

Poland adopted a different instrument, the Dual Indexed Mortgage (DIM).[37] With a DIM, the *principal* is adjusted according to inflation, and the amount of *repayment* is adjusted for changes in average wages. DPMs and DIMs have different advantages and risks to both borrowers and lenders. The principle of the DPM was introduced to Hungary by USAID; USAID also actively supported usage of the DIM in Poland.

Implementation was difficult in both countries, not least because the mortgage instruments were unfamiliar, and were—to put it mildly—difficult for borrowers to understand, and for bankers to explain to their customers. Both countries experienced a very slow start-up period, during which few loans were made. In both cases, the instruments became popular as a result of successful marketing by the State Savings Banks. In Hungary, this resulted from a combination of an extensive campaign—supported by USAID—to change the attitudes of staff of bank branches, combined with a new subsidy[38]. In Poland, the bank PKO BP used its already-large network of branches and internal training systems to market the loans successfully.

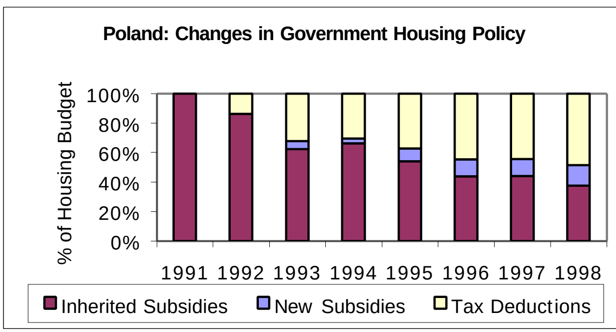
- In conditions of high inflation or where changes in inflation are likely, low-start (indexed or adjustable) mortgages are required to make home loans affordable to middle income borrowers and to protect lenders' resources. No single mortgage instrument is appropriate to all circumstances.

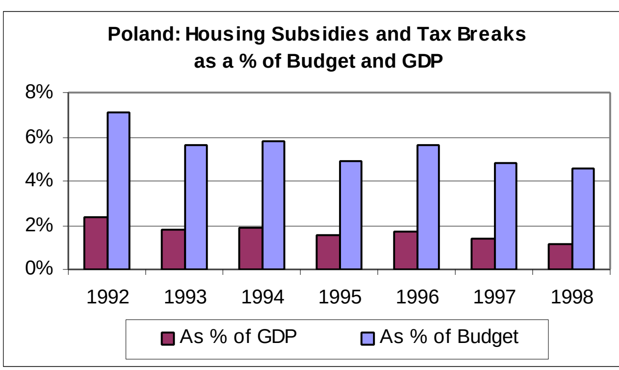
- Since these mortgages are difficult to market and to originate, it is necessary for banks, donors or central government to invest heavily in training branch staff members.

- It is also necessary to use sophisticated marketing techniques (e.g. highly simplified explanations of the instruments) to help the public to understand when and how these instruments could be of benefit.

- The initial development of the sector was undertaken without such special instruments and was, indeed, led in the first place by banks undertaking conventional lending to high income households. Further growth of the sector, needing much higher volume lending, could only have been undertaken—in the circumstances of Poland and Hungary—using some variant of a low start mortgage.

Subsidies Both Poland and Hungary relied on deep and widespread subsidies to stimulate residential construction (in cluding income tax subsidies in Poland, and subsidized mortgage lending in Hungary)—see box below. These appear to have been more successful in reducing the decline in house building in the early 1990s than in neighboring countries[39]. However, it is not obvious that the social benefits have been equivalent to the very high financial costs to the public purse.





Note: Both charts exclude tax foregone by reduced VAT on building supplies, and housing subsidies paid by local governments

Some parts of the subsidy system in these countries have clearly been inimical to the development of a market-based housing finance system. For example, Polish local governments provide heavy subsidies for rents in public housing. There is a clear justification for subsidizing poor households. Nevertheless, the Polish system has a number of undesirable effects, including the continuing existence of a massive disincentive for households to move from (poor quality but heavily subsidized) public to private housing. The small proportion of income spent on housing has encouraged unusually high levels of expenditure on cars and other consumer items. It also perpetuates the perception that housing is a social right, for which payment of more than—say—5 percent of income is unreasonable.

Principles of an Effective Subsidy System[40]

- ***Targeting*: ** Subsidies should be cost-effective: they should not benefit people who can afford to pay.
- ***Fairness*: ** Subsidies should be progressive (benefits decrease as income progresses). Households should expect to bear a reasonable proportion of housing costs.
- ***Transparency*: ** Policies should be understandable, and administered in a clear and equitable manner, according to published rules.
- ***Supporting Private Market Development*: ** Policies should not compete with market mechanisms.
- ***Economic Efficiency and Limited Redundancy*: ** Policies should achieve the desired impact with as little public expenditure as possible. Policies should not do what the private sector will do on its own.
- ***Administrative Efficiency*: ** Policies should be designed to minimize administrative time and cost.

From an examination of the loan subsidy systems in Poland, Hungary and other central European countries, Diamond concludes that

> *"deep loan subsidies [for housing] seem to encourage large amounts of lending associated primarily with taking out loans in order to substitute for other funds that earn a higher return. Such lending activity can encourage more lenders, but only if the subsidies are channeled through conventional lenders. Moreover, such subsidized lending may not acclimate the public to borrowing at unsubsidized rates."*[41]

- Although subsidies are often justifiable for supporting low income households and, under some circumstances for stimulating construction, if badly designed they can be harmful to state and local budgets and detrimental to the development of an equitable and efficient housing finance system.

In summary:

There is no single "best model" of housing finance. Different approaches have been adopted around the world both for an effective primary market and for accessing funds from the capital market.

- In every country, a different array of institutional and financial arrangements is necessary to suit particular circumstances.

- A level playing field should be maintained for all institutions active in the housing finance market. Competition among these institutions is crucial.

- ♦ A country does not need a secondary market in order to begin lending in housing finance. Efficiency in primary market functions is the important first step in the long-term development of a housing finance system. Funding loans through banks' deposit base is a typical means of starting the activity, given sufficient liquidity in the banking sector, and provided that long-term loans represent a small share of the banks' assets.

- ♦ In the long-run, however, a source of long term funds is necessary and desirable. There are many options of varying degrees of sophistication for doing this, including the establishment of mortgage banks, or the creation of a secondary mortgage market.[42]

PAMBank: Poland's First Housing Bank

In the first phase of the reforms in Poland, the macroeconomic conditions, over-generous subsidies, and legislative shortcomings discouraged the development of market based mortgage lending. However even in such an environment it proved possible to initiate some lending on a limited scale.

PAMBank—the Polish-American Mortgage Bank—was provided initial funding in 1991 by USAID, through the Polish American Enterprise Fund. Lech Gajewski, the first president of PAMBank and father of its successes, believes that the creation of the Bank and the start of mortgage lending only three years after the beginning of the country's overall economic reforms was "more like a development experiment than a purely commercial decision".

With access to some long-term capital, and know-how technology from the American Dime Savings Bank, PAMBank issued its first 15-year dollar-denominated mortgage loan in 1993. The clientele was the small group of households with hard currency incomes, among the first beneficiaries of the economic reforms. By 1998, the Bank had managed to access additional funding from the market and had built a mortgage portfolio worth over $ 40 million. This was the first bank to prove that commercial mortgage lending can be a real business opportunity for profit-seeking lenders. Its primary competitive advantages were a simple product, strong marketing and a high level of customer services. In the following years, PAMBank became a unique source of expertise after transforming the experience of its American partner into Polish field-tested practices and procedures.

Distinct from banks involved in the Mortgage Fund Program, PAMBank addressed the problem of affordability by lending in dollars at 10%, at a time when the cost of equivalent DIMs was at a level of some 30%. In exchange, its clients were exposed to a major currency risk. To reduce the repayment risk, President Gajewski's team paid special attention to sound underwriting and strong credit analysis procedures.

In 1999, General Electric became a strategic investor in the bank, which took on the name of GE Housing Bank.

5. BUILDING INSTITUTIONAL CAPACITY

Poland's Prime Movers

Access to skilled, motivated people is one of the most important preconditions for successful development of any sector.

In the initial phases of development, one or more well positioned public officials are needed to set and nurture an overall policy for the creation of a market-based housing finance system. In the case of Poland, the initiators of the process included real estate and banking experts with prior experience of housing finance systems in developed economies. Supported by prominent politicians from reform-oriented political parties, like Leszek Balcerowicz, they were able to lay the groundwork for future reforms.

In the second phase of development, the first experienced practitioners appeared, many of them foreign experts. They helped in the design of the first regulatory and lending procedures, as well as in training Poland's first mortgage lenders.

The next, critical, point was the appearance of a nucleus of local bankers who made mortgage lending their professional specialization. There were various paths for their route to the sector. A few experts had prior international mortgage lending experience, although the biggest group of pioneers comprised people with general banking experience or even from outside the banking sector. It was often due to a coincidence and/or their foreign language skills that they were able to meet USAID, World Bank or EBRD experts and became attracted to the mortgage market. Another group of Polish specialists appeared as a result of the extensive training provided in connection with the Housing Guaranty Program. For example, USAID sent over thirty Polish bankers to the Fels Course at the University of Pennsylvania. At the same time hundreds of others were trained by Fannie Mae and USAID specialists at courses within Poland.

Starting in 1996, three bank training institutes developed a professional mortgage lending training curriculum. The training material had been prepared by a group of the most experienced Polish practitioners under the USAID funded program. As of mid-2000, over 800 credit officers from over 20 banks have participated in the courses on a fee-paying basis.

Professionals who graduated from PAMBank, the Mortgage Fund (BudBank and the Housing Finance Project Office), as well as some of the most innovative employees of PKO BP, comprised the first cadre of Polish experts who brought their experience to other banks and helped them establish their own mortgage lending programs.

The Principles As with most complex systems, the capacity of the housing finance system draws heavily on the strength of the institutions comprising its various components: in the finance sector itself, as well as those in the surrounding environment (the real estate professions, consumer knowledge, builder/ developer capacity, the permitting and land disposition process, availability of infrastructure, housing choice).

The process of reaching maturity within each of these subsectors ultimately relies on development of each of the others in order to reach full capacity. It is *not*, however, absolutely inhibited at any particular moment in time by the slow growth of other components. For instance, banks in Poland have dramatically increased their capacity in mortgage lending. But this growth has not substantially been held back by the lack of full capacity within the building or municipal sectors.

Nevertheless, as incomes rise, inflation falls, and demand increases, so problems in these other sectors will become increasingly significant in restraining growth. Perhaps sufficient focus and pressure will then be applied to find resolution to these capacity problems.

The experience in Hungary and Poland is not sufficiently long-lived to be able to draw conclusive “lessons learned” on which sectors have proved the most critical, or how best to address continued blockages. At best, the following paragraphs simply identify the components of the larger system that continue to play a role within housing finance, and describe how some sectors have begun to mature.

Bank Capacity Polish banks have demonstrated their capacity to lend by issuing 100,000 mortgages by mid-1999. Training was critical to the new banks which, unlike PKO BP, were unfamiliar with mortgage lending. These banks have now been able to streamline their procedures: in 1994, the average application processing time was close to 9 months (admittedly this included the complex procedural steps required by the Mortgage Fund); today most banks process an application in one to two weeks. The individualized training first undertaken for USAID has been turned into a full training curriculum, recognized by the Polish Bank Association and taught at three banking institutes—see *Mortgage Training in Poland*, page 54.

In 1997, the Polish Bank Association also formed a permanent Housing Finance Committee, with a salaried secretariat, and which embraces most of the principal Polish banks engaging in lending for housing.[43] This has a mandate to exchange experience among member banks, and to represent the interests of mortgage lenders to government, parliament, and other partners. Together with the Mortgage Credit Foundation (representing the interests of the specialized mortgage banks), it has been instrumental in promoting housing finance issues in public and legislative arenas.

In Hungary, the OTP training department has taken over training in the DPM, which continues to be a product offered to the public. USAID funded training of OTP trainers. Hungary also has an active and successful International Bankers Training Center.

Banking Supervision Attempts were made in Hungary to engage the bank supervision department in the national bank in housing sector reforms but, as little interest was expressed, the effort was abandoned. In Poland, considerable training, modeling, and policy assistance was provided to what appeared an interested beneficiary, the National Bank of Poland's Bank Supervision Department. However, interest flagged, and mortgage lending issues are again subsumed under general bank supervision. While some risks to the market may be considered high by the standards of western Europe or the U.S., an established bank supervision system, undifferentiated into mortgage and commercial banking, may be quite sufficient.

- Bank supervision is critical, but a separate function for mortgage lending may not be worth the cost, or effort, to get it established in the early years.

From Builders to Developers The construction process in both countries continues to reflect patterns developed in the 1970s; like many other components of the system, the developer industry has not evolved as quickly as anticipated. In Hungary, self-built units heavily predominate, with only 20% of building undertaken by developers. In Poland, cooperatives remain significant builders, but with individual construction also predominating.

Developers are distinguished from builders in their ability and willingness to take the construction risk, to finance a project with funds other than those provided by the future buyers during the process of construction. Though the process of owner finance has in its own way become standardized and streamlined, developer finance would prevent the chronic hold-ups in construction and would improve quality as buyers would be freed to select the best units, and therefore to benefit from market forces.

In Poland, the capacity-building process was accelerated by a series of training seminars for developers on construction finance, by hands-on assistance to a group of developers working with the Mortgage Fund program, by the establishment of a professional association representing the interests of small builders and developers, and by the creation of a few firms specializing in real estate advisory services, at least one of which was formed from ex-employees of the Housing Finance Project Office, itself created to support the Mortgage Fund.

Construction Loans are available in both countries and, though underutilized compared to Western Europe and the U.S., they have played a role in new housing construction. The loans are typically for bridge financing, to finish a building that has been largely built with the equity from future owners. This places the primary risk on the buyers, rather than the builders—it is critical to distinguish between a builder and a developer. In Hungary, two banks are also making condominium rehabilitation loans, lending to associations rather than to individuals.

The Real Estate Professions It was one of USAID's goals from the start of our assistance program in Poland to facilitate the broader evolution of private property markets. Key obstacles included a lack of training, and of institutional representation to make the market work (especially regarding valuation methods, assessment of market feasibility, and real estate brokerage). Small teams of U.S. experts made contact with newly-established brokers, brokerage firms and appraisers, and made presentations in Polish markets where there was significant activity in the real estate market. Interested brokers and appraisers then formed incubator associations, with funding from USAID.

Assistance was provided by the Eastern European Real Estate Federation, which has been working since 1992 to utilize the experience of the U.S. National Association of Realtors in order to facilitate the creation of real estate professions and organizations. As a result, the Polish Real Estate Federation—see box on next page— was established in 1994; it now has 19 regional associations, with 1,500 member brokers; the Polish Federation of Valuers' Associations was established in 1995; it now has 29 regional associations, with well over 3,000 member appraisers.

In 1998 Poland had almost 8,800 companies registered as operating in the real estate market (in 1993 there were only 1,200). Real estate brokers and valuers account for over 60% of this number, private developers another 7%. per 1000 people.

The Polish Real Estate Federation (PREF)

PREF was established in 1994 as the Polish Federation of Real Estate Brokers Associations, currently representing around 1,500 professional real estate brokers, in twenty regional associations. PREF is a fully self-sufficient, not-for-profit, professional organization which offers its members a wide range of services, including regional and national conferences, training programs, publications, business tours to other European countries and the U.S. The Federation actively participated in the development of real estate market legislation, and successfully represents its members in front of Parliament, Government and other national institutions. PREF and its members have, in recent years, established a number of partnership programs with the (U.S.) National Association of Realtors, and with other professional groups like the North Virginia Association of Realtors, and the Institute of Real Estate Management of Chicago.

The Role of Local Government Local governments are key participants in the process of housing development among other ways, as providers of infrastructure services for land; holding responsibility for planning and building permits, therefor controlling the speed and cost of building; often owning much of the vacant land; as well as holding the all-important role of managers of much of the communal housing stock.

Slowness and irregularities in permitting are still cited as factors hindering efficient construction, as is the difficulty in accessing public land. Builders have responded in the interim by avoiding public land and building on private land on the peripheries of urban centers— with the unintended consequence of exacerbated urban sprawl and traffic congestion. In Hungary, renovation has become an increasingly important component of urban housing. In Poland, a system of municipal finance has been established which has resulted in dramatic increases in municipal borrowing for infrastructure, both through subsidized environmental loans and on the commercial market—although, according to the

World Bank, the level of borrowing is still way too low in relation to municipal needs.

The process of building capacity for Polish local governments to be effective, responsive and accountable has taken the best part of the decade, and even now may not be regarded as being fully complete. The lessons learned from this process are too numerous to be included here, but can be found in a separate USAID publication.[44]

Policy and Research Capacity In both Hungary and Poland, a few key people consistently provided much of the policy advice over the decade. By most accounts, this has resulted in the most critical component of policy-making—a change of thinking towards the roles of government and private sector. Many have built research and policy firms to provide an institutional base for their ongoing work—see boxes, *Building Policy and Research Capacity*, below.

Through a series of training programs, conferences, and policy discussions—many of which were sponsored by USAID—a coherent group of leaders in housing finance expertise has emerged. These people are called upon to participate in most policy discussions. They have also developed sufficient reputation to be listened to as respected critics of policy initiatives. Their involvement throughout the decade, helped them build their institutions, and develop the organizational capacity to continue as viable research and policy firms into the future.

Building a Policy and Research Capacity (1)
The Metropolitan Research Institute (MRI)[45]

Jozsef Hegedus and Ivan Tosics founded MRI in 1989 in partnership with several foreign friends, as a not-for-profit private company. Ivan and Jozsef had had a consulting company for some years, doing survey research for the government as well as participating in the international world of housing finance. MRI's big start came, however, as a contract to represent Hungary for the World Bank's housing and urban assessment in 1990. Though the Bank and Hungary did not reach agreement, MRI became known to USAID. USAID designed a housing program for Hungary; in 1993 MRI became a subcontractor to USAID's primary contractor, the Urban Institute.

MRI, working hand in hand with U.S. advisors, has provided the core of housing policy work for the government over the past seven years. They have written the policy background papers for most of the major issues discussed within government, and often drafted the policies. Jozsef sits on the Housing Policy Committee, and heads the subsidy subcommittee. Their opinion is heard, although it has not always prevailed. They are credited with helping to change the policy principles upon which housing is debated, bringing in transparency and efficiency in subsidies, income targeting, and a system of analysis and evaluation to develop and refine programs.

USAID has provided the greater part of MRI's business over the past 7 years although it always had other clients, including central and local governments. With the closure of USAID/Hungary in July 1999, MRI is going through a restructuring, as well as a serious strategy process to define its future. Its future is somewhat dependent on the EU and access to foundation funds. Like CREI—see next page—MRI has seen itself as a think tank, and has had more success and personal reward from doing new and innovative activities than repetitive training. And like CREI, MRI faces the dilemma of expanding its income base by becoming a consultancy but perhaps jeopardizing its role as a think tank. CREI is certain *of* its commitment to the latter; MRI might have the same preference, but may not have the option.

Building A Policy And Research Capacity (2)
The Cracow Real Estate Institute (CREI)

Wladyslaw Jan Brzeski, the founder of CREI, fled Poland with a friend when he was 19. Because he had a relative in Canada, he departed the Italian refugee camp for Western Ontario, finishing his studies and marrying before moving on again to Sweden. Leszek Balcerowicz who, as Minister of Finance in 1991, is credited as the as the force behind Poland's economic "shock therapy" called Jan into the service of the new Poland as his housing advisor. Together, they defined an agenda for creating a market-oriented finance system: privatized banks providing mortgage credits without subsidy, a freely moving real estate market supported by new professions, elimination of market distorting subsidies, break-up or conversion of the formerly state-controlled cooperatives. The World Bank, USAID and EBRD supported the new policy with technical advice and capital—a commitment of $425 million for a mortgage fund. The Ministry of Finance founded the Mortgage Credit Foundation as the counterpart to the donors, an institution that included Jacek Laszek and Edward Koslowski, as well as Jan, all of whom were to play key, and changing, roles in the development of Poland's housing finance system.

Jan returned to Cracow (Krakow) in 1992 to found CREI. His departure from Warsaw was partly triggered by an internal change of power base for the mortgage program from the Ministry of Finance to the Ministry of Construction. Jan did not stay long as its director, as he resigned later in the year to avoid conflict with his new post as deputy mayor of Cracow. Jan was to come and go from the Institute as he came and left public office, but always remained its true leader. When asked if Jan would return to the Institute after his second term as housing advisor to Mr. Balcerowicz, CREI's managing director Bogdan Rogatko confirmed what appeared to be obvious—that he had never left.

CREI has been the base of support for most real estate and housing initiatives over the past 8 years. It has been the Polish housing and real estate group most used by USAID and by the World Bank, and part of almost all housing policy efforts USAID has undertaken in Poland.

The Institute has the largest real estate library in the country, a collection open to students and professionals alike. It has managed dozens of national and international conferences. With the Real Estate Federation, it publishes a quarterly magazine on real estate, *Real Estate World*. It has received new funding from international sources to continue work in urban development, property tax and housing policy.

It is difficult to separate CREI from Jan Brzeski. Jan and his colleagues created the first reform agenda for Poland; that agenda continues to guide the Ministry of Finance and much of the country's housing policy makers. Jan has only been in government a small part of the past eight years, but his presence has represented a consistent voice for mortgage finance and real estate market liberalization. That voice, though not always responded to, is always heard.

6. MANAGING THE DEVELOPMENT PROCESS

There are a number of conclusions to be drawn from the successes (and—to be honest— occasional failures) of the way that USAID, our partners and counterparts managed our programs of assistance for the development of the housing finance systems in Poland and Hungary.

USAID's program of assistance to Central and Eastern Europe began in 1989; housing was one of its first components. Primarily because of the drain on national budgets, the housing sector had been identified by the governments of Poland and Hungary as a key area for foreign assistance. The assessment process was started in 1990 by the World Bank, bringing in experts some of whom would later become instrumental in the USAID program, and others who have continued to this day as key policy advisors.

In both countries, USAID's housing program began with a heavy emphasis on finance, reflecting the critical debt problem of inherited housing subsidy schemes. From the start, however, the assistance programs aimed also to address the other key components of the sector—development of local government capacity, of the private construction sector, and of the real estate professions. The World Bank soon ceased its activities in Hungary but, through the Mortgage Fund in Poland, continued its presence until 1997. International experience was sought by both countries. Experts from France, Britain, Germany and other transition countries, as well as from the United States, were invited to give advice—in the case of our housing finance assistance program, as a policy decision by USAID to help Poland choose the course most appropriate for its culture, economy and legal background.

Perhaps the primary lesson, as in other sectors, was that ambitions were initially too high—the development of a housing finance system takes time; it is a process not an action; and its success depends heavily on other macroeconomic features that themselves may take years to mature.

The USAID program accomplished much of what it set out to do—but over a much longer period of time than originally anticipated. The mortgage system was established in both Poland and Hungary; government policy became far better informed. The volume of mortgage lending has been relatively small, to the extent that its role in improving household choice and supporting overall economic reform has—until recently in Poland—not been significant. And—at least according to one observer in Hungary—government policy, while better informed, is still "a tool of people wanting to stay in power rather than economic rationality".

- Development of a housing finance system is a long-term business. Donors and government managers must expect to be engaged over a period of several years; they need to maintain a consistent vision of the desired end-state, as well as a pragmatic approach to implementation.

- Housing finance embraces issues of public finance as much as of commerce. It is necessary that the commercial sector (bankers), the professions, the public sector and the media be engaged in the development process, and that, so far as possible, these groups be encouraged to engage in a continuing dialog.

Policy Advice USAID was able to play a consistent and valuable role partly because of its own structure and staffing (with permanent, specialist, staff in the field). The housing program, especially in its formative stages, had program managers who had both the time and mandate to focus on the program, and the technical knowledge to design, refine, and provide ongoing motivation for the program.

- The consistent presence of technical advisors was accepted by key policy makers. In both Hungary and Poland, short term expatriate advisors formed teams with local experts, which became the mainstay of policy advice to the government. The local experts were part of the policy process from the beginning, and through their connection to the government, have maintained access for the consultant teams during various shifts of government.

- Commissioning policy research activities has created a nucleus of housing professionals in both countries, who now share a common perspective as well as familiarity and trust of each other. Many of the key housing experts in Poland, for instance, were trained at the Wharton School's housing finance course in the University of Pennsylvania. This laid the ground for common intellectual and personal connections.

- We were also able to access first class international experts as part of our consulting team, and to retain these experts, intermittently, over a long period of time. These experts were quickly able to build up a deep knowledge of Poland, and to generate a level of trust among their Polish counterparts.

Training As noted in previous pages, USAID sponsored many training events over the course of our decade of involvement in the sector. The culmination of the mortgage lending training program in Poland is summarized in the following box. Insofar as a goal was to build sustainable training courses, as distinct from providing one-off training events which end with the assistance program, it was necessary to build several elements into the development of a training program:

- The creation of a forum for developing consensus on the approach to training, and for reconciling competitive commercial tensions: in Poland, USAID provided a model curriculum and convened the first meetings of providers and users; the Polish Bank Association provided course recognition;

- Identification of potential trainers from within the existing mortgage lending system, and training them as trainers; and
- Demonstration to training institutes that demand exists, if necessary by means of providing pilot courses.

Mortgage Training in Poland

In the fall of 1996, USAID—as part of its Housing Finance Program in Poland, launched a Mortgage Training project. Its primary goal was to develop a high quality indigenous, sustainable training system that would instill mortgage lending skills in credit officers in banks active in home lending.

The program has succeeded in:

- gathering together, on a routine basis, a group of the most experienced Polish practitioners from leading lending institutions, as a sort of steering group for training development;
- developing three detailed training courses (Mortgage Lending; Construction Lending for Single Family Homes; and Lending for Developers);
- developing a body of ten or more Polish trainer/ practitioners educated in interactive training techniques; and
- institutionalizing training within three bank training institutes. In January 1999, the three institutes signed an agreement with the Polish Bank Association (PBA) to share the costs of further training development, maintain the quality of training materials, and establish permanent channels of communication between the schools and PBA as the representative of client banks.

The schools estimate that, in the last three years, they have organized some 37 training courses in the area of housing finance for loan officers from many of the Polish banks active in the housing market.

Introductory seminars or conferences can be useful to provide basic information to inspire banks and others to pursue entry into the system. Developer seminars were provided to increase interest in mortgage finance. In Hungary, USAID sponsored a training conference with introductory sessions on a number of subjects pertinent to bank lending. Ten banks attended and, though the subjects were not covered in depth, it was sufficient for the bank staff to return to their headquarters and suggest further engagement in the mortgage market. Had this seminar been held earlier on, it might have inspired a more competitive environment and/or the incentive for more institutionalized bank training.

Dissemination It was a basic tenet of the USAID program in Poland that a market-based housing finance system could be established neither rapidly nor robustly unless there were widespread understanding and acceptance of the principles of the proposed system by the general public, as well as by the professional groups who would implement it.

Different audiences required different messages, and for which different media were more appropriate. However, it also became obvious that our audiences were not well defined, especially at the start of the transition. We therefore necessarily used a shot-gun approach to information dissemination at the outset, later narrowing the targets as people's concerns and interests became better defined.

Among other things:

- We sent out our technical reports—in Polish and English—to as wide a group of individuals as might be interested;
- In order to foster confidence in our findings, we emphasized the need for high quality of the translation and presentation of the reports, as well as of their substance;
- We held periodic conferences to generate continuous debate on issues of importance by all the main players;
- We invited media representatives to many events, and provided them with briefings;

- Data generated by our consultants were shared as widely as possible; only commercially-sensitive information was withheld.
- At the conclusion of the program, the Urban Institute and the Cracow Real Estate Institute established websites; the addresses are given in the Reference section at the end of this paper. These websites include the main published reports, and links to the sites of our main partners.

Capital Funding: The Housing Guaranty Program
The USAID housing program had access to both a loan instrument—the Housing Guarantee (HG) loan program: see box on the next page—and grant funds for technical assistance.

The capital funds were important for two reasons. For one, the initial funding enabled new, small banks without substantive assets to enter the mortgage market and thus provide competition to the dominant lender, PKO BP. In Hungary, some speculate that the same would have happened had the government borrowed. The volume of lending generated by the HG loan did not have a significant impact on the market, but the Polish case seems to indicate that the Fund laid the ground for what is now serious competition.

A main benefit, particularly in countries such as Poland and Hungary with substantial savings and access to capital markets, is the focus that a loan fund can provide. In both countries, the loan and its conditions forced a coherent response from the government, which prompted the formation of the Housing Policy Committee in Hungary and the Mortgage Credit Foundation in Poland. While the responsible ministry in Warsaw clearly saw mortgage finance as one component of the system but chose to focus on social housing and the real estate industry, the Fund always demanded some attention for the mortgage system and its barriers.

The apex lender system also served to bring clients and lenders into discussion on how to improve the overall Polish mortgage

USAID's Housing Guaranty Programs

The Housing Guaranty (HG) program provided a 100% guaranty to a U.S. lender for its loan to a foreign government. An equivalent amount of activity to the loan must be generated in local currency equivalent. The loan negotiations include a set of conditions precedent for the initial and subsequent borrowings; these become the policy instruments.

The $25 million Poland HG was designed to contribute to the Mortgage Fund, a capital fund created through a $200 million loan from the World Bank, $67 million from EBRD, and $123 million from the GOP, for a total of $425 million. While the HG complemented the World Bank loan, it was somewhat more flexible in its requirements. The first tranche of $10 million was borrowed in 1992; this was to be the only tranche, finally liquidated in 1999. The World Bank loan was subsequently reduced to $20 million.

USAID's $10 million financed only a few hundred mortgage loans. However, as evidenced by the history recounted in previous pages, the project objectives were met in full insofar as the Mortgage Fund established standards for mortgage lending, and demonstrated to banks the feasibility and profitability of mortgage and construction lending, and demonstrated to the public the feasibility and benefits of mortgage borrowing. As Margret Thalwitz of the World Bank said, "although the Mortgage Fund may have been a box office failure, it was undoubtedly an artistic success".

The Hungary HG was to be a $60 million loan in three phases. It was negotiated in 1993, signed in 1994, but after the government had resolved its debt crisis, Hungary had access to hard currency funds on the open market at what they believed were lower rates. The loan was therefore never borrowed.

system. The design of the Mortgage Fund included a technical office not only responsible for monitoring the fund, but also for providing technical assistance to developers and builders to help create demand. As loans began to be processed by participating banks, USAID hosted a forum with representatives of builders and the banks who began to meet to discuss their respective problems and perspectives. Its occasionally turbulent discussions helped identify key problems for resolution. The process helped standardize the loan applications coming from builders for both construction and take out mortgage loans, and helped the interface between the Mortgage Fund and the participating banks become more streamlined.

The promise of the loan thus provided a forum for discussion and decision making on housing finance. In both cases, this then became a coherent means for providing training, identifying key leaders to support, and an attentive audience for policy inputs. Even in Hungary, the promise of the loan gained sufficient attention to pique the interest of banks in the mortgage market, leading in several years to at least four entering the market.

- ♦ Capital funds, or even a promise of capital assistance, can be instrumental in providing a focal point to achieve policy objectives. A number of donors other than USAID could provide these funds.

Timing Finally, the questions arise whether donor assistance is really needed to support the development of a market-based housing finance system; and at what stage of development of the sector technical and/or capital assistance is most useful.

There are countries in central Europe that have made the transition to a market-based housing finance system without the use of any significant amounts of donor finance—the Czech Republic is one example. In most cases, however, these countries have had access to commercial assistance from foreign banking interests. We do not have sufficient evidence to prove unambiguously that donor-assisted systems are "better" than those without. We do, however, sincerely believe that USAID and the other donor agencies in this sector have:

- accelerated the speed of change in Poland and Hungary, and have thereby helped the sectors the reach a level of maturity considerably earlier than would otherwise have happened;
- helped institutionalize a common approach to market-based housing finance in many of the institutions—in the public and private sectors, research institutes and media outlets—that is essential for robust (sustainable) development of the sector; and
- lobbied for a level playing field that encourages competition, thus in the long run a more efficient, effective and fair housing finance system.

USAID started work in the housing sector in Poland and Hungary soon after the transition. By offering capital assistance before the market was ready for mass growth, we have been accused of prematurity. This may be the case. However, the environment is complex, and cannot be quantified: the preceding pages identify many, but by no means all, of the factors that condition its change. In practice, it is impossible to forecast the precise time at which a system is ready to move to the next stage of development.

In addition, there are strong political and commercial forces—especially in post-communist countries—which have an interest in subverting the principles that we have espoused: not least, the need for competition, transparency, and effective use of public funds. If there are few, or weak, objective commentators, there is a real risk that those forces may take the upper hand. We conclude then, that if a donor agency has a choice between early or late engagement in the sector, earlier involvement is strongly preferred.

- ♦ The issue, then, is not so much of *when* to assist, but of *how* to assist. Support can and should be given from the beginning of the reform process if there is an unequivocal commitment by the national government to introduce a market-based housing finance system. The only issue is which techniques to use in order to bolster the process of change, a question that may be assisted by the discussion in the preceding pages.

Other Lessons Learned

- We over-estimated the capability of some local institutions to quickly take on the responsibilities we expected of them. Institutions have their own internal dynamics which—with the best will in the world—cannot immediately assimilate foreign, new development philosophies.

- We also had a tendency to under-estimate the time needed for individuals or institutions to change their mind-sets, especially those (Poles or Hungarians) brought up under a system of central planning, or those (foreigners) with extensive experience of housing finance in economies on the other side of the world. We also often under-estimated the determination of those people with commercial or political interests in maintaining the status quo, or in the creation of new subsidies. Persistence and understanding are needed to effect change, as well as sound logic and good powers of persuasion.

- In Poland, we found it essential to stay involved with the whole range of institutions engaged in creation of a new housing finance systems: the Ministries of Finance and of Housing (which took on various names during our lifetime in the country), the banking sector, training and academic groups, private sector developers and builders, the real estate professions, and the media. It is doubtless vain to claim that USAID was the catalyst that brought these groups together; but our work would certainly not have as effective if we had omitted to include any of these in our dialogs.

- Finally, we used to hear disparaging remarks about those short-term consultants and would-be advisors who flew in to

Warsaw or Budapest, dispensed words of wisdom about how to put the world to rights, and then returned home after a stay of one or two weeks. We believe that their critics were often justified. Instead, we tried—from our bases in USAID's Poland and Hungary Missions—to provide advice grounded in local reality; and to utilize a team of consultants able to return periodically over a longer period of time, thus to understand the local situation and appropriate solutions, as well as to develop sustained relationships with their local counterparts.

Annex: The Evolution of the Sector: Poland, 1990-2000

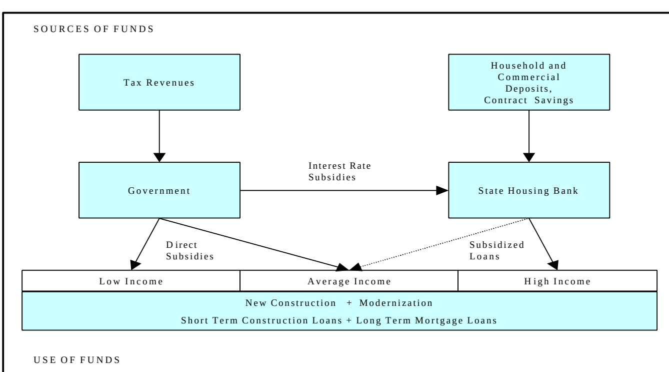
	Banking Milestones	Institutional Milestones
1991		* Housing Finance project office established * Mortgage Credit foundation created
1992	* PKO BP declares intention to end subsidized lending to cooperatives	
1993	* PAMBank offers first $-denominated mortgage loan	* Housing Allowance program * Rent-setting authority given to muncipalities
1994	* Mortgage Fund finances first loan * PKO BP delcares intention to end subsidized lending to individuals	* PAHB formed * PFREB formed
1995	* PBK offers first mortgage loan * PKO BP offers first non-subsidized mortgage loan	* National Housing fund established to support subsidized lending to non-profit housing associations (TBS) * PFVA formed
1996	* PKO BP disburses last subsidized loan * First 100 mortgages from Mortgage Fund * 4 Mortgage Fund supported banks and 3 others offer mortgage loans	* Mortgage Credit Foundation re-established * HFPO dissolved; CREI/ Warsaw and REAS established * EBRD withdraws from sector * Kasy Mieszkaniowy contract savings schemes start
1997	* About 20 banks offer long-term housing loans * 4 banks participate in the Mortgage Fund * 5 basic mortgage loan instruments available * USAID survey reports 4% of the population has taken a housing loan * PBA creates Housing Finance Team	* Mortgage Banking Act passed * Bausparkasse legislation passed (but not effected) * First bank training institute offers housing finance courses independent of USAID * Official statistics show first upturn in housing completions * Several newspapers start publication of weekly housing supplements
1998	* 28 banks offer long-term mortgage and construction loans * Net growth rate of mortgages exceeds 40% p.a. * Bud-Bank announces entry into retail lending	* Ministry of Finance re-examines Bausparkasse and Statutory Lien legislation * HUDA's first housing policy strategy * 3 bank training institutes offer housing finance courses * PAHB reaches financial independence
1999	* Mortgage credit continues to increase at annual rate of 90% * 200 TBS created: construction of over 5,200 units * Licences granted for first Mortgage Banks	* Numerous proposals for demand-oriented legislative revisions in pipeline * Agreement between PBA and bank training institutes * Polish chapter of IREM formed

	USAID Milestones
1991	* FNMA conference on housing finance * RHUDO established
1992	* HG program to support Mortgage Fund authorized * HBI/APHBI program initiated * EERPF assistance initiated * First local housing support agency (AWIM) established
1993	* $10 million HG loan to Mortgage Fund
1994	* First training courses for developers * RHUDO Director receives Polish state honor for services to housing
1995	* NAHB/RC begins support to PAHB * PADCO appoints resident Mortgage Banking Advisor
1996	* TBS manual and software published * Full-time training development advisor appointed * National conference on training for housing finance * 600 bankers attended USAID-supported courses on construction lending; 450 developers received tech. assistance * Lublin community development project receives Best Practice Award for Excellence from UNCHS (Habitat)
1997	* National conference on the future of housing finance * Report "Building on Progress" widely distributed * Workshop on housing finance regulation with NBP; series of reports on regulatory issues * First IREM courses offered
1998	* USAID advises MoF and HUDA on reform of Kasy Budowlane legislation * Recommendations to MoF on reform of Statutory Lien * Study Tour to U.S. by PBA members * LGPP initiates housing and land management assistance programs * HG loan completely drawn down
1999	* Recomendations on public housing policy * Seminar (with MCF) on mortgage insruance * Mortgage bank simulation model completed * National and regional “agenda-setting” conferences * USAID housing finance program completed

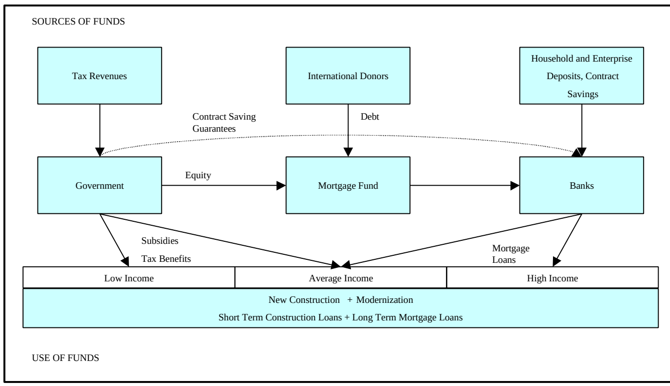
Acronyms used in this table

APHBI American Polish Home Builders Institute
CREI Cracow Real Estate Institute
DIM Dual Indexed Mortgage
EBRD European Bank for Regional Development
EERPF Eastern European Real Property Foundation
FNMA Federal National Mortgage Association
HBI Home Builders Institute
HG Housing Guaranty
HUDA Housing and Urban Devt. Authority
IREM Institute of Real Estate Management of Chicago
IBRD World Bank
LGPP Local Govt. Partnership Program
MCF Mortgage Credit Foundation
MoF Ministry of Finance
NAHB National Association of Home Builders
NBP National Bank of Poland
PADCO Planning and Development Collaborative International, Inc.
PAHB Polish Association of Home Builders
PBA Polish Banks Association
PFREB Polish Federation of Real Estate Brokers
PFVA Polish federation of Valuers' Associations
REAS Real Estate Advisory Services
RHUDO Regional Housing and Urban Development Office
TBS Towarzystwo Budownictwa Spolecznego (Public Housing Association)

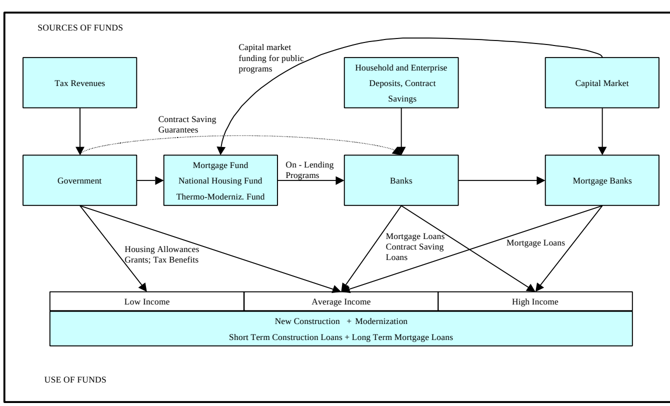
Poland's Housing Finance System, 1992



Poland's Housing Finance System, 1996



Poland's Housing Finance System, 2000



Sources and References

All references marked * can be found at, and downloaded from, www.polandhousingfinance.org
They can be found in Polish at: www.kin.cc.pl/polhousfin

All Urban Institute documents can be obtained from the following address: The Urban Institute, 2100 M Street, N.W., Washington, D.C. 20037, USA.

Certain other documents relating to housing finance in central Europe can be found at the following website:
www.info.usaid.gov/regions/europe_eurasia/local_gov/reports.html

Other documents describing USAID's assistance to the housing sector, can be found on USAID/Warsaw's homepage:
http://ntwarsa01/aidpoland

[1] See also Merrill, Sally and others, *Housing and the Macroeconomy*. Urban Institute Consortium for USAID/Warsaw, April 1999. *
[2] Pogodzinski, J.M., "The Effect of Housing Market Disequilibrium on the Supply of Labor", 1993, quoted by Mayo, Stephen K. and James I. Stein, "Housing and Labor Market Distortions in Poland: Linkages and Policy Implications", in *Journal of Housing Economic*s 4, 1995, pages 153-182
[3] Wladyslaw Jan Brzeski comments: "During the 1990s Polish households preferred to spend their newly won disposable incomes on cars and foreign travel. My ballpark figures for 1997 showed for example, that Poles spent about 10 billion on new dwellings, a similar amount on new cars and twice as much on foreign travel, while only fraction of these amounts on maintaining the housing stock."
[4] R. Ibbotson, L. Siegel, K.Love, "World Wealth: Market Values and Returns" in *Journal of Portfolio Management*, Autumn 1985.
[5] Polish Central Statistical Office, *Statistical Yearbook 1999*, pages 539-561. Warsaw, 1999.
[6] But note that much residential mortgage debt in the West is used for financing non-residential consumption and investment activities. In Poland, these activities are financed through direct borrowing without the use of mortgages.
[7] Merrill, Sally and others, *Poland: Housing Finance at the Millennium. An Assessment of Achievements and Outstanding Issues.* Urban Institute Consortium for USAID/Warsaw, February 2000. Page 7 *

[8] Based on Lee, Michael, *USAID's Program of Assistance to Poland's Housing Finance Sector, 1991-1999*. USAID/Warsaw. December 1999.

[9] Urban Institute, *Building on Progress: The Future of Housing Finance in Poland.* For USAID/Warsaw, May 1997. *

[10] Recorded housing completions fell from 134,000 in 1990 (and 284,000 in 1978) to a low point of 62,000 in 1996. The official statistics exaggerated the actual decline, however: the annual number of housing starts averaged about 100,000 through the 1990s.

[11] Herbst, Irena, "Financing the Building Industry in Poland", in *Housing Finance International,* August 1990, page 42.

[12] Thalwitz, Margret, "Poland: Building a New System of Housing Finance", in *Housing Finance International*, December 1993, pp 13-16.

[13] Among other incentives to build, the government introduced income tax relief on expenditures for new construction—an indirect subsidy that proved partially effective in bolstering the rate of house construction, but poorly-targeted and politically difficult to abolish.

[14] Urban Institute. *Building on Progress*, op.cit.

[15] See Mayo, Stephen, "Housing and the Economy", in Merrill, April 1999, op.cit.

[16] PBK and BISE. The latter had a credit line from Credit Foncier de France, and its first loans were, in fact, refinanced from this source before the first loans from the Mortgage Fund.

[17] Diamond, Douglas, *The Transition in Housing Finance in Central Europe and Russia, 1989-1999.* Urban Institute Consortium for USAID/Warsaw. February 2000. page 103. *

[18] An excellent bibliography of reports on the development of Hungary's housing finance sector is included in Mark, Katherine and Margaret Tabler, *Hungary Program in the Local Government and Housing Sectors: Activities, Impact and Lessons Learned.* The Urban Institute, Washington, D.C., August 1999.

[19] 3% fixed interest loans were ended in late 1998, and replaced by a subsidy on variable rate loans. The new subsidy covers a portion of the repayment: up to 80% for new housing purchased by families with three children.

[20] Source: Cseh Pal, Ministry of Finance

[21] 1998 data, quoted by Diamond, February 2000, op.cit., page 12.

[22] There are currently thousands of foreclosure cases now in process, although most of these are based on pre-1989 loans, many of which have been in default for years.

[23] From Merrill, Sally. *Poland Housing Finance Project: Final Project Report*. The Urban Institute for USAID/Warsaw, April 2000.
[24] *Building on Progress*, op.cit. Section 4.
[25] A consequence of this state of affairs is that insurance is now offered to mortgage borrowers to bridge the period until which title is registered.
[26] Diamond, Febuary 2000, op.cit, pages11-18.
[27] Wladyslaw Jan Brzeski comments: "Notice also the problem of informality, shadow economy and general instability of income. Many households have significant portions of their incomes derived from unregistered and unstable sources, which cannot be recognized by lending institutions."
[28] Lea, Michael, *Analysis of Contract Savings Systems in Poland*. Urban Institute Consortium for USAID/Warsaw. March 1998.*
[29] Diamond, Douglas, *The Current Operations of the Bauspar Systems in the Czech Republic, Hungary and Slovakia*. Urban Institute for USAID/Warsaw. September 1998.*
[30] Lea, Michael, *Global Models for Funding Housing: What is the Best Model for Poland?* Urban Institute Consortium for USAID/Warsaw. February 2000.*
[31] Diamond, February 2000, op.cit., page 27
[32] Merrill (December 1998) quotes that, in July 1999, the average mortgage rate was 4% above the maximum deposit rate. The report finds that intermediation efficiency increased by about 30% between 1997 and 1999 although, with considerable fluctuation, the trend cannot be said to be steady. Several bankers claim mortgage spreads are—at the time of writing—closer to 2-3%.
[33] Mortgage insurance is offered by four companies, and used by most banks; credit enhancement mechanisms are used by BISE and LG Petro Bank.
[34] Data from Piotr Karas, Cracow Real Estate Institute
[35] For a good general discussion of these problems and possible solutions, see Jeffrey P. Telgarsky and Katherine Mark, "Alternative Mortgage Instruments in High-Inflation Economies" in *Housing Finance Internation*al, September 1991, pages 27-46.
[36] Diamond, Douglas B., *Hungary's Experience with the Deferred Payment Mortgage*. The Urban Institute, March 1999.
[37] Chiquier, Loic, *Dual Index Mortgages: Conditions of Sustainable Development in Poland*. Urban Institute Consortium for USAID/Warsaw. February 1998.*
[38] Diamond, March 1999, op.cit.

[39] Diamond, February 2000, op.cit.
[40] Summarized from Merrill, Sally and others, *Public Sector Housing Finance Policy Strategies for Poland*. Urban Institute Consortium for USAID/Warsaw. December 1998.*
[41] Diamond, February 2000, op.cit, page 26
[42] From Merrill, Sally, *Poland Housing Finance Project: Final Project Report*. The Urban Institute for USAID/Warsaw, April 2000. See also Lea, Michael. *Global Models for Funding Housing: What is the Best Model for Poland?* The Urban Institute for USAID/Warsaw, February 2000.*
[43] The Director-General of the Polish Bank Association is reported to have credited a senior advisor of USAID with being "the driving force" for the formation of the Committee. See Kopstein, Ken. *USAID Assistance Program to Poland in Local Government and Housing Sector Reform.* MSI, for USAID/Warsaw. July 2000.
[44] Kopstein, op.cit.
[45] See also Struyk, Ray J., *Reconstructed Cities: Think Tanks in Post-Soviet Bloc Democracies.* The Urban Institute Press, Washington, D.C., 1999.